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SUBJECT: SERBIA: GAZPROM DRILLING DEEPER INTO ENERGY SECTOR

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SUMMARY

1. (SBU) Russia's energy giant Gazprom continues to make inroads into Serbia's energy sector, six months after it secured a deal giving it a majority stake in Serbia's state-owned petroleum company NIS. Through Gazprom, Russia is now following through on investments in both oil and gas and is considering branching into Serbia's domestic banking sector to finance these investments. The moves are not without controversy, with questions mounting about NIS's accounting practices and poor management. Despite these close ties to Gazprom, Serbia has little assurance that it will not fall victim to any future energy crisis. End Summary.

NEW INVESTMENTS IN NIS

2. (SBU) Following the sale of Serbia's state petroleum company NIS in December 2008 to Russia's Gazprom (reftel A), its new owners have begun allocating funds to upgrade facilities. NIS intended to invest \$118 million in 2009 to modernize, Aleksandar Cirilovic, President of the Democratic Party's Energy Committee and advisor to NIS President Dmitry Malishev, told us on May 31. Of these funds, \$68 million would be used to upgrade NIS's refinery in the town of Pancevo and \$50 million was to improve NIS's environmental quality and controls. Cirilovic said he expected NIS would fulfill this investment even though there were widespread accusations surrounding NIS's accounts.

NIS' BOOKS A MESS

3. (SBU) A recent audit of NIS by KPMG discovered that NIS had losses of \$119 million in 2008. These losses resulted mostly when NIS returned an estimated \$100 million in dividends to state-owned firms that were indebted to NIS, including JAT (airline), Srbijagas (gas company) and Putevi Serbia (highway company) in order to cover these firms' debts to NIS prior to the sale to Gazprom. In addition, NIS's current General Director Kiril Kravchenko told the media on June 2 that NIS suffered additional losses of \$160 million in the first quarter of 2009, due to lower energy prices and falling demand during the economic downturn. Serbian members of the NIS board have requested a new audit, but this was only likely to confirm KPMG's audit, Cirilovic told us. Ernest & Young is the most probable choice for that audit, according to our sources.

NIS MANAGEMENT A MESS

14. (SBU) In addition to accusations of sloppy books, there are numerous complaints about how NIS was managed prior to Gazprom's arrival as well as accusations of continued mismanagement, with both Serbians and Russians pointing fingers - and blame - at the other. The Russian Embassy's Deputy Chief of Mission Vladimir Ulasevic told Charge on June 23 that prior to NIS's sale, the company's management "was in shambles." He said the Serbian government had used NIS as a "cash cow," laying blame with the Democratic Party (DS). Other parties have had their hands in NIS as well. Until July 2008, NIS was controlled primarily by the party of former Prime Minister Kostunica, the Democratic Party of Serbia (DSS). But according to DSS Vice President Nenad Popovic, who spoke to Charge on June 16, the "Yellows" (DS) took a perfectly good company and ruined it, before the Russians came to town. Ever optimistic about Russia, however (Popovic got rich manufacturing energy equipment in Russia, see <http://www.absholdings.biz/eng/about/>), Popovic claims that following a 2010 feasibility study, Gazprom will break ground on a South Stream pipeline in 2011.

15. (SBU) NIS's management is now increasingly under the control of Russian management. Those Serbian members who are on the board have little, if any, energy industry experience and are politically divided, as is common with state companies in Serbia. Cirilovic said he expected the current Serbian members of the NIS Managing Board would be replaced at the next NIS Assembly session, expected in September. (As of June 30, two Serbian members had already resigned from the NIS board.)

16. (SBU) Criticism of current NIS management is also coming from other state owned companies. Srdjan Mihajlovic, director the state-owned oil pipeline company Transnafta, told us on June 10 that he still had not had a meeting with NIS's new management, even though Transnafta was NIS's most significant customer. He said the new

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Russian management had come with little experience and had excluded competent Serbian energy experts who used to hold management positions in NIS from the current decision making process. Mihajlovic also expected and urged the dismissal of politicians from NIS's Board.

GAZPROM SQUEEZING MORE FROM SERBIA?

17. (SBU) Analysts believe Russia was well aware that NIS was being used for political purposes by the Serbian government in prior years. Analysts suspect that NIS's new Russian management may be highlighting the company's financial losses now in an effort to further undervalue NIS in order to extract new concessions from the Serbian Government. Specifically, NIS is seeking government permission for higher prices for crude oil processing, citing NIS's poor performance in the first quarter of 2009, Cirilovic told us on June 9. NIS also wants exclusive rights to import Euro Diesel into Serbia, which would generate greater revenue streams for NIS and could further limit competition.

18. (SBU) Gazprom may be seeking to acquire additional shares of NIS, former NIS director Milos Saramandic told us on June 11. According to the December 2008 Serbia-Russia energy deal, NIS is to be transformed from a closed shareholding company into an open shareholding company, meaning its shares are to be quoted on the Belgrade Stock Exchange (to become effective in early August). Gazprom has priority purchasing rights for these shares and analysts believe undervaluing NIS shares would make it cheaper for Gazprom to buy them, Saramandic said.

GAZPROM WORKING WITH SRBIJAGAS

19. (SBU) In addition to investing in NIS, Gazprom is expanding its cooperation with state-owned gas company Srbijagas, as was envisioned in the December 2008 agreement. Specifically, Gazprom is to form a joint venture with Srbijagas by the end of June in order to fill Serbia's Banatski Dvor gas reserve, which would have a capacity of 300 million cubic meters. On May 18, Director of Srbijagas Dusan

Bajatovic (SPS) said he wanted this project completed by December 2009, but this is technically infeasible. Bajatovic has also been courting Gazprom Export and Gazprom Bank in order to secure financing for the Banatski Dvor project. According to media accounts, Gazprom Bank is interested acquiring a local Serbian bank, such as Univerzal Bank, Privredna, or Agrobanka, primarily to fund this and other energy projects in Serbia.

COMMENT

¶10. (SBU) Gazprom's purchase of NIS has thus far not resulted in a very happy marriage - with accusations abounding about who is to blame - but both sides are determined to move forward. Serbia, increasingly the junior partner in this venture, is putting a lot of faith in Russia's willingness to fulfill its energy commitments in Serbia without renegotiating terms. The test will be whether Gazprom follows through on upgrading NIS's facilities and filling its commitments to Srbijagas, even in this difficult economic climate. If Gazprom does not uphold its end of the bargain, the government's decision to partner with Russia on energy matters may become a political liability. End Comment.

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